

RECEIVED

JAN 31 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20250

In the Matter of

Price Cap Performance Review
for Local Exchange Carriers

)
)
)
)
)

CC Docket No. 94-1

DOCKET FILE COPY ORIGINAL

COMMENTS OF
SOUTHWESTERN BELL TELEPHONE COMPANY

ROBERT M. LYNCH
DURWARD D. DUPRE
THOMAS A. PAJDA

One Bell Center
Room 3520
St. Louis, Missouri 63101
(314) 235-2507

ATTORNEYS FOR
SOUTHWESTERN BELL TELEPHONE COMPANY

January 31, 1995

No. of Copies rec'd
List A B C D E

044

COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY
CC Docket No. 94-1

Table of Contents

<u>Subject</u>	<u>Page</u>
Summary.	i
I. THE USTA PROPOSAL REPRESENTS A REASONABLE BALANCE OF INTERESTS	3
A. The USTA Proposal is a Concrete Positive Step Toward Needed Fundamental Regulatory Reform	3
B. The USTA Proposal Achieves the Commission's Goals of Ensuring That LEC Access Services Are Fairly and Reasonably Priced	4
C. The USTA Proposal Assures That Access Customers Will Participate in the Benefits of LEC Productivity Improvements . .	5
D. The USTA Proposal Provides Market-Based Investment Incentives Without the Disincentives and Distortions Created by Residual ROR Regulation	6
E. The USTA Proposal Narrows the Categories of Costs that Qualify for Exogenous Treatment	7
II. THE USTA PROPOSAL IS CONCEPTUALLY AND THEORETICALLY SOUND	7
A. The USTA Proposal is Based on Sound Economic Principles and Provides Benefits to Customers in a Manner That Replicates Competitive Markets	7
B. The Rolling Average Productivity Offset is an Appropriate Substitute for Earnings Sharing	9
C. The USTA Proposal is a Reasoned Set of Steps, with the Degree of Regulatory Relief Appropriate to the Showing that Has Been Made	9
III. THE EVIDENCE WARRANTS ADOPTION OF THE USTA PROPOSAL	12
A. Efficiency Considerations Require That LECs Be Given Greater Pricing Flexibility	12
B. The LECs Have Already Demonstrated, as a Threshold Matter, that the Competitive Landscape Warrants Adoption of the USTA Proposal	13

C.	Adoption of the USTA Proposal Would Provide Significant Consumer Benefits By Encouraging the Introduction of New Services	14
IV.	OTHER PARTIES WILL UNDOUBTEDLY TRY TO DISCREDIT USTA'S PROPOSAL AS AN ATTEMPT TO UNJUSTIFIABLY ENRICH THE LECS	15
V.	PARTIES HAVE DISTORTED THE RELATIVE BENEFITS OF PRICE CAP REGULATION	16
A.	C.A.R.E. Has Misrepresented the Goals of Regulation and the Performance Under the Commission's Price Cap Plan for LECs.	17
1.	C.A.R.E. Has Not Demonstrated That LEC Earnings Have Been Unreasonably High	17
2.	C.A.R.E.'s Allegations Regarding LEC "Disinvestment" are False.	18
B.	MCI's Use Of EBITDA Data is Irrelevant to Price Cap Regulation	19
1.	MCI Projects a Distorted View of the Value of Price Cap Regulation	19
2.	MCI Takes the Commission's 1990 Statement Regarding the Conservative Nature of its Productivity Estimate Completely Out of Context	20
3.	MCI Incorrectly Calculated Return on Equity ...	20
VI.	THE COMMISSION SHOULD MOVE NOW TO MODERNIZE REGULATION OF THE PRICE CAP LECS	21

SUMMARY*

SWBT strongly supports the proposal filed by USTA on behalf of the local exchange carriers (LECs). The proposal presents a solution to the Commission that would modernize regulation of interstate access services in a manner consistent with the changing environment.

The USTA Proposal presents a reasonable balance between the needs of the parties to this proceeding. The proposal accelerates the expected benefits of an improved regulatory environment in the form of early across-the-board reductions in the prices of interstate access services. More importantly, however, it is a proposal that will ensure greater consumer benefits resulting from sharpened LEC efficiency and investment incentives.

By its current proposal, USTA has bifurcated its request for fundamental pricing and access structure reform into more manageable segments. The USTA Proposal, even as bifurcated, is a reasoned set of steps that will move regulation toward the needed fundamental reforms.

Because the USTA Proposal includes an adaptive productivity offset, the interests of customers, LECs and the public are balanced. The rolling-average productivity offset component of the plan ensures that customers will benefit from all future increases in productivity that may occur.

Customers are demanding new services and options that the current regulatory structure significantly delays or prohibits. Adoption of the USTA Proposal will promote the

* All abbreviations used herein are referenced within the text.

introduction of these new services and options, benefitting all parties.

The Commission should be wary of the claims that are being made in this docket by those who say they are in favor of incentive regulation, but then propose modifications designed to benefit them alone. These parties, for example, have incorrectly claimed that LEC earnings have been unreasonably high and that LECs have been disinvesting in the regulated business. The Commission should reject these fallacious arguments.

The current LEC Price Cap Plan has generated the benefits the Commission contemplated. The time has come to begin to bring LEC regulation into line with the competitive interstate access markets that exist today, and the Commission's regulation of other carriers.

RECEIVED
JAN 5 1965
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

CC Docket No. 94-1

COMMENTS OF SOUTHWESTERN BELL TELEPHONE COMPANY

Southwestern Bell Telephone Company (SWBT), pursuant to the Public Notice¹ released January 24, 1995 by the Federal Communications Commission (Commission), hereby files its comments on the USTA Proposal for the LEC Price Cap Plan. SWBT strongly supports the proposal filed by USTA on behalf of the local exchange carriers (LECs). The proposal presents a solution to the Commission that would modernize regulation of interstate access services in a manner consistent with the changing environment.

While the hybrid brand of price cap/ROR regulation that was adopted by the Commission in 1990 may have been a cautious first step appropriate for the environment in the late 1980's, it is outmoded for the environment in 1994 and beyond. Changes that the Commission has made since the plan's implementation have added additional pricing restraints and complications to the plan, even though interstate access markets have become

¹ Public Notice, DA 95-102, released January 24, 1995, seeking comments on the United States Telephone Association (USTA) ex parte filed on January 18, 1995, entitled "A USTA Proposal for the LEC Price Cap Plan," in CC Docket No. 94-1 (USTA Proposal).

increasingly competitive² and customers' expectations have expanded beyond the scope of the current regulatory structures.

In the past four years, while the LEC price cap plan has been slipping back toward ROR regulation, the Commission has removed virtually all of AT&T's business and commercial services from price cap regulation. The Commission also implemented a pure price cap plan, without earnings sharing, for cable TV providers. It also implemented much simpler, more streamlined regulatory plans for smaller LECs who were not made mandatorily subject to the LEC price cap plan. The Commission's regulation of price cap LECs must be modernized now; customers expect this and the investment community will settle for nothing less.³ SWBT strongly urges the Commission to adopt the USTA Proposal.

² During the 1987-89 debate about price cap regulation, the Commission designed a price cap plan for AT&T so that AT&T's most competitive services had the greatest pricing flexibility. Subsequently, the Commission incorrectly modified its design so that the plan for LECs imposed the least amount of pricing flexibility for the LECs' most competitive services. Implementation of the USTA Proposal begins to correct this fundamental design flaw in the Commission's Price Cap Plan for LECs.

³ SWBT has presented evidence that end user access customers expect SWBT and other LECs to be active and aggressive competitors and that from their perspectives as customers, current rules prevent this from occurring. See, e.g., "Free to Compete: Meeting Customer Needs in the Provision of the Public Network" filed with SWBT's Reply Comments that responded to SWBT's Transmittal No. 2297 to its Tariff FCC No. 73, and cited in SWBT's Comments in this docket at p. 10, fn. 29. SWBT has also presented substantial evidence that investors expect to keep pace with changes in markets, i.e., that regulation should allow LECs to compete. See, e.g., SWBT ex parte contacts dated January 5, 1995 with Commissioner Susan Ness and James Casserly, Legal Advisor and Commissioner Rachelle Chong and Richard Welch, Legal Advisor.

I. THE USTA PROPOSAL REPRESENTS A REASONABLE BALANCE OF INTERESTS.

The USTA Proposal presents a reasonable balance between the needs of the parties to this proceeding. The proposal accelerates the expected benefits of an improved regulatory environment in the form of early across-the-board reductions in the prices of interstate access services. More importantly, however, it is a proposal that will ensure greater consumer benefits resulting from sharpened LEC efficiency and investment incentives. Adoption of the components of the USTA Proposal is required to give interstate access customers the benefits of competition. Current rules tie the hands of the LECs, preventing them from being aggressive competitors in exactly those interstate access markets where new and large consumer benefits are possible.

A. The USTA Proposal is a Concrete Positive Step Toward Needed Fundamental Regulatory Reform.

Unfortunately, it appears that the Commission will not be able in the next few months to complete the needed fundamental reform of the LEC price cap plan that USTA outlined in its access reform petition filed in September, 1993 and described further in its comments, reply comments and ex parte communications filed in this proceeding. From SWBT's perspective, and from the perspective of many other LECs, the USTA Proposal for fundamental price cap and access reform has been the single most important LEC initiative to be placed before the Commission in the past year. Moreover, the need for fundamental

reform of the Commission's access charge rules is widely recognized by the Commission and non-LEC parties.⁴

By its current proposal, USTA has bifurcated its request for fundamental pricing and access structure reform into more manageable segments. The USTA Proposal, even as bifurcated, is a reasoned set of steps that will move regulation toward the needed fundamental reforms.⁵ Now is the time for modernizing access regulation.

B. The USTA Proposal Achieves the Commission's Goals of Ensuring That LEC Access Services Are Fairly and Reasonably Priced.

The USTA Proposal incorporates design components that ensure that customers will receive interstate access services at fair and reasonable prices. In the shorter-term, the USTA Proposal calls for price caps as the preferred form of customer protection. In the longer-term (upon completion of the second phase of the USTA Proposal), a regulatory regime is adopted where the Commission would streamline explicit price cap regulation where a showing is made that competition is sufficient to warrant such action.

Because the USTA Proposal includes an adaptive productivity offset, the interests of customers, LECs and the public are balanced. The rolling-average productivity offset component of the plan ensures that customers will benefit from all future increases

⁴ Access Reform Task Force, Federal Perspectives on Access Charge Reform: A Staff Analysis, April 30, 1993.

⁵ The USTA Proposal is a highly integrated package of reforms which cannot be considered piecemeal. For example, the proposal for a 1% up-front reduction in price caps, a 1% CPD (to be phased out), and a narrowing of exogenous costs, are integrated with and predicated on the expected benefits from the elimination of sharing, which, together, are all integrated with the construction of the rolling average productivity offset. The proposal must be considered in its entirety. SWBT is vehemently opposed to piecemeal consideration of the components of the proposal.

in productivity that may occur. The Commission cannot know now what the future path of LEC productivity will be. LECs have argued that the acceleration of competition will reduce their near-term productivity by shrinking the base of higher-contribution services, leaving the LECs with lower productivity and services that historically have been priced below cost due to regulation. The LECs' competitors have argued that future "technological explosions" will be greater than the significant innovations of the past and that LEC productivity growth will rise in the future. These two opposing views are reconciled by adopting a rolling-average productivity offset that adapts to productivity changes as they occur.

C. The USTA Proposal Assures That Access Customers Will Participate in the Benefits of LEC Productivity Improvements.

Because a rolling-average productivity offset ensures that 100% of the benefits of increased efficiencies flow through to price reductions, access customers will benefit by the full effects of all of these efficiencies. However, as in competitive nonregulated markets, those benefits are provided to customers with a lag. Recognizing that such a lag exists in competitive nonregulated markets, but based on understanding of the Commission's desires for consumer benefits, the USTA Proposal recommends that expected future customer benefits be accelerated into early years of a new plan. This is done by the inclusion of a 1% up-front reduction in price caps and a 1% Consumer Productivity Dividend (CPD) that is phased out. These two provisions "front-end load" the expected benefits from a new price cap plan into the early years of implementation.

Increases in expected consumer benefits are possible only if the disincentives present in the current plan are removed. By "front-end loading" the plan, access customers

immediately receive the benefits from the new regulatory environment. As described in the USTA Proposal, SWBT would not support a plan that included an up-front reduction in price caps or a higher CPD unless earnings sharing is eliminated and an appropriate productivity offset is adopted. If earnings sharing is retained, there will be no sharpening of incentives and no increase in expected consumer benefits. Quite the contrary, unless the LECs are allowed the same pricing flexibility and efficiency incentives as their competitors, they will face drastically shrinking market opportunities and significantly reduced earnings in their regulated business. As a result, no acceleration of expected (but unattainable) future consumer benefits would be warranted.

D. The USTA Proposal Provides Market-Based Investment Incentives Without the Disincentives and Distortions Created by Residual ROR Regulation.

Earnings sharing retains the strong disincentives to investment in the regulated portion of the telecommunications business, in the same manner as cost-based ROR regulation.⁶ From an investor's perspective, any form of earnings sharing significantly dampens incentives. Investors and entrepreneurs will seek options that avoid investments with limitations or constraints on rewards. Investment seeks out opportunity; if opportunities do not exist, investment will go elsewhere. If business managers and institutional investors do not perceive the opportunity for market-based returns on investment, they are forced to seek other alternatives.

⁶ Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, (FCC 89-91) (released April 17, 1989) paras. 29-35; Second Report and Order, (FCC 90-314) (released October 4, 1990) paras. 21-37.

The USTA Proposal continues to recommend the removal of earnings sharing. This is a fundamental design component of the plan that must be implemented promptly. The surest means of ensuring that the American public benefits from telecommunications investments is to remove the artificial disincentives caused by earnings sharing. LECs are a very important potential source for increased investment in the U.S. telecommunications sector. The removal of earnings sharing is the engine that will accelerate investment in the regulated telecommunications sectors.

E. The USTA Proposal Narrows the Categories of Costs that Qualify for Exogenous Treatment.

By narrowing the categories of costs that qualify for exogenous treatment, the USTA Proposal significantly simplifies the LEC Price Cap Plan and strikes an appropriate risk/return balance given the other components of the USTA Proposal. The controversial nature of exogenous changes through the first four years of the LEC Price Cap Plan has been substantial. Significant resources would be saved by all parties in the future under this component of the USTA proposal.

II. THE USTA PROPOSAL IS CONCEPTUALLY AND THEORETICALLY SOUND.

A. The USTA Proposal is Based on Sound Economic Principles and Provides Benefits to Customers in a Manner That Replicates Competitive Markets.

The basic goal of regulation is to replicate competitive market results. The USTA Proposal for a rolling-average productivity offset meets that objective as described below. In nonregulated competitive markets, individual firms are encouraged to "build a

better mouse trap" by the increased returns that such an innovation provides. Thus, firms expect to benefit from their increased efficiencies. Over time, other firms attempt to match the results of an innovator and eventually "compete away" the lasting benefits to the innovating firm.

The rolling average productivity offset proposed by USTA is the most appropriate way to capture unique LEC productivity gains for the purpose of assuring that LEC prices reflect those gains. It does so in a manner that replicates the way competitive nonregulated markets assure that customers subsequently receive the benefits of those gains.

Under the USTA Proposal, LECs would be allowed to retain the full benefits of increased efficiency in the first year, but would have those benefits passed on to customers as the rolling-average productivity measure captures the benefits of innovation. As an attachment to the USTA Proposal, USTA presented the rationale for the use of a rolling average and, specifically, the rationale for selecting a moving average of 5 years. SWBT supports the use of a 5-year moving average as the minimum number of years that would be appropriate. Adopting a timeframe of this length recognizes the extended length of time required to deploy capital widely throughout the LECs' networks and the amount of capital required to provide access and local exchange services. In the USTA Proposal, by the fifth year of the moving average, 100% of any increased efficiencies would be provided to access customers in the form of lower access prices.

Total factor productivity (TFP) is the only theoretically sound and practically possible method of establishing a productivity offset that will stand the test of time. Christensen Associates (on behalf of USTA), Selwyn (on behalf of Ad Hoc) and AT&T all

agree that TFP is the only way to measure productivity. It is the only method of measurement that correctly accounts for the contribution to productivity of all factors of production, including both labor and capital. In 1990, when, the Commission adopted its estimate of historical LEC productivity, it did not have a principles-based measure of total factor productivity specific to the price cap LECs, as it does now in the Christensen productivity study.

B. The Rolling Average Productivity Offset is an Appropriate Substitute for Earnings Sharing.

The elimination of sharing, together with the rolling average productivity offset and other principles-based "safeguards" for access customers (CPD, etc.), will eliminate distortions and send the right signals to the external investment community. Investors expect regulation to keep pace with change in the marketplace. For those with the responsibility to maximize shareowner value, the elimination of sharing will also eliminate the disincentives inherent in the current rules to invest in the regulated local exchange telephone companies.

Sharing was added to the LEC price cap plan as a temporary backstop to unanticipated errors in productivity.⁷ The adoption of a rolling average productivity offset

⁷ The Commission concluded in 1990 that

possible sources of errors in the productivity offset support the adoption of a backstop program (at least until we acquire additional experience with LEC price caps) to adjust rates in the event that such unanticipated errors in the price cap formula occur.

will facilitate the elimination of sharing by eliminating errors in the productivity offset. However, even without the rolling-average productivity offset, sharing should be eliminated. Inclusion of the rolling average in the proposal provides additional consumer benefits.

C. The USTA Proposal is a Reasoned Set of Steps, with the Degree of Regulatory Relief Appropriate to the Showing that Has Been Made.

Some parties may incorrectly claim that the Commission should not adopt the USTA Proposal because it represents a relaxation of regulation. SWBT earnestly insists that path for reform must be expanded pricing flexibility for the LECs and a design that promotes efficient investment decisions.

There are aspects of the Commission's theoretical construct of price caps that are fundamentally sound. Price caps provides incentives for increased efficiency; it allows the movement of prices to more efficient levels; it significantly reduces -- and, in its pure form, completely eliminates both the incentive and ability to cross-subsidize. The USTA Proposal rigorously maintains and improves on the conceptual elements which contributed to the success (as far as success was possible) of the existing LEC price cap plan.

The USTA Proposal deals with the regulation of interstate access, the subject of the current price cap proceeding. Other parties have suggested that the Commission cannot proceed with modernizing its regulation of interstate access markets without examining the entire competitive landscape of all telecommunications services, including local exchange competition. It would be wholly inappropriate for the benefits of improved interstate access regulation to be delayed based on the competitive characteristics of an entirely different market. Moreover, the Commission need not, and in fact should not, require fully competitive markets prior to implementing an adaptive regulatory framework.

In order to maximize the benefits of competition, an adaptive framework needs to be in place prior to the development of competition. SWBT firmly contends that the case for increased pricing flexibility for interstate access already has been convincingly made.

As precedent, the Commission has already employed a stepped approach in its relaxation of price cap regulation of AT&T services, examining and removing them from explicit price regulation on a market-by-market basis.⁸ Though the USTA Proposal suggests that the Commission deal with interstate access markets geographically rather than on a nation-wide basis, as it did for AT&T, the basic approach is similarly stepped.

In addition to supporting the USTA Proposal, NYNEX has proposed an additional option. Specifically, NYNEX recommends that -- as an alternative to adopting the integrated proposal of a rolling average productivity offset, a 1% up-front reduction to price caps, a phase out of a 1% CPD and the elimination of sharing -- a LEC be allowed to eliminate sharing based on a competitive showing.

SWBT maintains, and has so stated to the Commission in presentations demonstrating the significant degree of access competition in SWBT's territory, and specifically in its larger market areas (e.g., Houston), that the presence and growth of competition is a potent factor to consider when contemplating regulatory change. The

⁸ The fact that AT&T's interstate services were not subject to earnings sharing regulation made it possible to remove services from price cap regulation without requiring the Commission or AT&T to develop arbitrary cost allocation schemes to simultaneously remove costs from a sharing calculation. This fact is a key reason why SWBT and USTA contend that the elimination of earnings sharing is a very useful first step for facilitating the subsequent removal of specific interstate access service market areas from explicit price cap regulation. For example, it would allow the orderly movement to Competitive Market Areas (CMAs), once the necessary showing has been made, as described in the USTA proposal for integrated price cap and access reform.

presence of competition enforces price discipline on market participants, thus alleviating the need for regulation in markets where those conditions exist. The presence of competition also requires that LECs be allowed significant pricing flexibility.

However, SWBT believes that the competitive showing suggested by NYNEX is irrelevant and that sharing should be eliminated in the current price cap review.⁹ The record already establishes sufficient cause to eliminate sharing. Sharing was imposed by the Commission as a temporary backstop for errors in productivity and has no explicit link to a company's earnings.¹⁰ The USTA and SWBT positions previously filed in this docket outline what SWBT believes to be the proper rationale for elimination of sharing and the appropriate criteria for examination of competition and the correct regulatory responses that should follow satisfaction of those competitive criteria.

III. THE EVIDENCE WARRANTS ADOPTION OF THE USTA PROPOSAL.

A. Efficiency Considerations Require That LECs Be Given Greater Pricing Flexibility.

⁹ SWBT believes that the suggested criteria for demonstrating the degree of competition in access markets that were presented by NYNEX are not the appropriate criteria for evaluating and triggering further increased pricing flexibility for interstate access services. The appropriate criteria should examine competition in access markets themselves and should not include criteria specific to other markets, such as local exchange competition.

¹⁰ The earnings of AT&T and MCI were above the earnings of the LECs, even though the Commission has concluded that the competitiveness of AT&T and MCI markets are sufficient so as to not require earnings sharing. Thus, specific Commission actions support the conclusion that the presence of competition and the level of earnings are not directly related.

The Commission previously found that a plan that allows prices to move toward their economically efficient levels is in the public interest.¹¹ Certain parties to this proceeding, however, would have the Commission adopt a plan that would restrictively require extremely steep, unwarranted across-the-board price reductions year after year. A group calling themselves Customers for Access Rate Equity (or C.A.R.E.), argue that a fixed productivity offset of 5.7% should be imposed on the LECs. To do so would fundamentally reverse the Commission's decision that carriers should have the ability to move rates toward more efficient levels. By imposing a punitive productivity offset, LECs would have no ability to rebalance rates or to respond to competition in markets where LECs have competitors.

B. The LECs Have Already Demonstrated, as a Threshold Matter, that the Competitive Landscape Warrants Adoption of the USTA Proposal.

SWBT and the other LECs have presented a substantial amount of evidence that demonstrates that there is today a significant amount of competition in access markets. SWBT presented data, for example, that demonstrates that approximately 95% of SWBT's DS1 and DS3 demand in downtown Houston originates in buildings where competitive access providers (CAPs) already have service.¹² This clearly indicates that access

¹¹ The Commission concluded that "it is more desirable to permit LECs to migrate their prices toward a set of prices that enhances efficiency. ... [P]ermitting flexibility in price-setting generates economic efficiencies that benefit ratepayers thorough lower rates." LEC Price Cap Order, para. 35.

¹² See, e.g., SWBT ex parte communications of November 22, 1994 with Karen Brinkmann of the Chairman's office, Kathleen Wallman, Chief of the Common Carrier Bureau (CCB) and members of the CCB staff.

customers in key markets do have alternatives today and that there are no barriers preventing customers from choosing those alternatives.

Other LECs have presented data on the extent of competition for interstate access services. For example, Pacific, GTE and NYNEX each have made detailed presentations to the Commission demonstrating access competition. The current presence of CAPs in virtually every medium to large telecommunications market in the United States today has already resulted in customers having different price alternatives. Due to regulatory restraints, only the LECs are prevented from actively competing in those markets.

More importantly, IXCs already have a significant amount of influence over LECs' pricing decisions. Unlike IXC markets, in access markets the LECs' three largest customers represent about two-thirds of all access purchases, including those made directly by end user customers. In many areas, IXCs are working with CAPs to provide alternatives to LEC-provided access. As a result, a significant amount of price discipline already exists in interstate access markets. AT&T, MCI and Sprint are very clear about their expectations for the LECs' price and service quality performance. The IXCs' expectations significantly affect LEC decisions. Thus, first and foremost, the IXCs, by their access purchase decisions and due to their ability to self-provision or jointly provide interstate access, are themselves formidable competitors to the LECs.¹³ Current restrictions prevent the LECs from competing with the IXCs.

C. Adoption of the USTA Proposal Would Provide Significant Consumer Benefits By Encouraging the Introduction of New Services.

¹³ MCI's formation of MCI-Metro is but one example of IXC competition for LEC access.

The Commission has an explicit objective to promote the deployment of new technologies and new services. To achieve this objective, the existing new service rules must be streamlined. The regulatory review and level of proof required by the current access structure rules, together with the waiver process and lengthy tariff review process, cause significant delays and burdens.

These delays must be significantly reduced and the burdens eased, if customers are to benefit from new services. Reform of these rules will ensure that the LECs will be able to respond effectively to existing market demands and will ensure that the public receives the benefits of advanced telecommunications technology and innovation without the unnecessary delays and caused by the current rules. Innovation has never fit neatly into the mold of the past; telecommunications is no exception. Adoption of the USTA Proposal will promote the introduction of new services, significantly increasing consumer benefits.

IV. OTHER PARTIES WILL UNDOUBTEDLY TRY TO DISCREDIT USTA'S PROPOSAL AS AN ATTEMPT TO UNJUSTIFIABLY ENRICH THE LECs.

There are parties who have tried and likely will continue to try to persuade the Commission that the benefits of price caps which were intended for those LECs that responded to the incentives in price cap regulation and generated positive earnings should now be confiscated from LEC shareowners and bestowed upon others. To do so would gut the plan.

Parties to this proceeding have stated that LECs have benefitted excessively from increased efficiencies. These parties clearly want benefits to be generated from incentive regulation of the LECs. However, they are attempting to acquire all of those

benefits for themselves. If some LECs responded to the incentives in the price cap plan more aggressively than the Commission or others had anticipated, and profited from this response, the conclusion must be that the plan worked.¹⁴ For incentive regulation to work at all, the incentives created must accrue to the party undertaking the risk and implementing the efficiency gain. This fundamental truth must not be lost.

After an accounting is taken of all of the changes that will be made by the Commission to the LEC price cap plan, and after, as USTA proposes, expected future benefits are accelerated into the early years of the new regime, the net of the incentives for efficiency and investment that exist for the LECs should be increased, not reduced. A retention of the existing sharing mechanism (or worse) will choke off the engine of incentives, killing efficiencies and investments.

AT&T, despite being a strong proponent of incentive regulation for itself, claims that the Commission should observe the LECs' recent earnings performance under incentive regulation and set prices as if the LECs had no incentives (i.e., hold the LECs' earnings to a flat level, despite the increased efficiencies that the regulation encouraged). Although AT&T supports sound economic principles for the regulation that applies to itself, it recommends fallacious principles for LEC regulation. Without the incentives provided by the Commission's hybrid price cap/earning sharing plan, LECs would not have had the financial incentives to cut overall costs or offer new services that reduce unit costs. Because incentives to be more efficient existed, the IXCs received significant financial and service

¹⁴ The Commission should not expect identical results for each regulated carrier and should not craft a plan with that as an objective.

benefits. The price cap LECs reduced access prices by a cumulative \$7.5 billion over the past four years.

V. PARTIES HAVE DISTORTED THE RELATIVE BENEFITS OF PRICE CAP REGULATION.

Through the course of the LEC price cap review, parties have engaged in distortion of facts (or worse) in their attempts to deprive the LECs of the benefits of efficiency and innovation. The Commission can expect that parties will make further unsubstantiated arguments against the USTA Proposal, many of which will be irrelevant to issues facing the Commission. In order to place these recent incorrect claims in context, it is useful to recount a number of these flawed arguments. USTA and individual price cap LECs have already provided a great deal of information on the record that disputes these false claims.

A. C.A.R.E. Has Misrepresented the Goals of Regulation and the Performance Under the Commission's Price Cap Plan for LECs.

An ad hoc group (C.A.R.E.)¹⁵ representing themselves as a "coalition created to work for LEC price cap reform" has made a number of misleading ex parte presentations in this docket. As accurately characterized, C.A.R.E. is a coalition created to persuade the Commission to roll back the limited reforms adopted in 1990. USTA and others have placed data on the record which illustrates the distortions presented by C.A.R.E.

1. C.A.R.E. Has Not Demonstrated That LEC Earnings Have Been Unreasonably High.

¹⁵ These claims were made by C.A.R.E. in its November 2, 1994 ex parte communication with Kathleen Wallman, Chief of the CCB and members of the CCB Staff.

C.A.R.E. alleges, without substantiation, that LEC earnings under price caps have been unreasonably high. SWBT, USTA and others have demonstrated that LEC earnings have been below market averages and below the IXCs.¹⁶

In any event, for C.A.R.E.'s allegation to somehow demonstrate a flaw in the LEC price cap plan, there must be an implicit assumption that as LEC earnings increase, consumer benefits decrease. In the absence of this assumption, C.A.R.E.'s allegation about LEC earnings would have no relevancy to the issue whatsoever.

The record shows that LEC access price declines have not necessarily resulted in lower long distance prices to end users. Recently, IXC prices have risen, while LEC access prices have continued to decrease.¹⁷

LEC earnings, which have demonstrated to be reasonable by comparison, have had nothing to do with the behavior of IXCs in terms of translating lower access prices to consumer benefit.

2. C.A.R.E.'s Allegations Regarding LEC "Disinvestment" are False.

¹⁶ For evidence on the reasonableness of LEC earnings, see, SWBT Reply Comments, filed June 29, 1994, pp. 16-20; see also, e.g., USTA ex parte communications of November 5, 1994 with James Coltharp, Legal Advisor to Commissioner Barrett; and BellSouth ex parte communications of November 15, 1994 with Richard Welch, Legal Advisor to Commissioner Chong.

¹⁷ At the same time, IXC shareholder returns since 1-1-91 (the period of the LEC price cap plan) have exceeded by far the total shareholder returns of the S&P 500. As a comparison, the total shareholder returns of the RBHCs have been below the S&P 500 over the life of the LEC price cap plan. See, e.g., BellSouth ex parte communications, dated December 8, 1994 with Kathleen Wallman, Chief of the CCB and members of the CCB staff.

C.A.R.E. has alleged that the RBOCs have been disinvesting in their regulated business. This allegation, too, has been shown to be false. SWBT has demonstrated that its investment in SWBT's telephone network increased 24% compared to the three years prior to price regulation and rose from 53.7% of available cash to 61.2% during the price cap period.¹⁸

a. MCI's Use Of EBITDA Data is Irrelevant to Price Cap Regulation.

In recent ex parte contacts, MCI has attempted to use an operating cash flow analysis to persuade the Commission that price cap LEC earnings are unreasonably high. MCI's use of EBITDA data is irrelevant to price cap regulation. All MCI accomplished with their EBITDA analysis was to demonstrate the obvious fact that the LEC industry is capital intensive.¹⁹

The flaws in MCI's approach have been exposed by USTA and NYNEX. These faults are recounted briefly as Attachment 1 to these comments.

In MCI's presentation on EBITDA, it made other "claims" based on distorted information. Several of these claims are addressed below.

3. MCI Projects a Distorted View of the Value of Price Cap Regulation.

¹⁸ See, e.g., SWBT ex parte communications, of January 5, 1995 with Commissioners Chong and Ness. Additional proof that the C.A.R.E. "disinvestment" claims are false has been provided by other LECs and USTA.

¹⁹ For additional rebuttal of MCI on this issue, see, USTA written ex parte communication, dated January 20, 1995, from Mary McDermott, VP & General Counsel, USTA, to William F. Caton, Acting Secretary, FCC; see also, e.g., NYNEX ex parte communications of January 9, 1995 with Kathleen Wallman, Chief of the CCB and members of the CCB staff; and BellSouth ex parte communications, of December 8, 1994 with Kathleen Wallman, Chief of the CCB and members of the CCB staff.

MCI argues that the value of LECs' earning above 11.25% has been much greater than the value of the Consumer Productivity Dividend. MCI's view is distorted. The ability to earn above 11.25% represents the entire potential value of price caps for the LECs. The appropriate comparison of achieved value by the IXC and other access customers must, in a similar fashion include all the components from which these customers obtained value from the plan. These include the reductions in prices caused by the total productivity offset, including the CPD, sharing, and the price reductions caused by common line demand growth. The total value to access customers of all of these sources of benefits from the LEC price cap plan has been at least \$7.5 billion.

4. MCI Takes the Commission's 1990 Statement Regarding the Conservative Nature of its Productivity Estimate Completely Out of Context.

In an effort to bolster its arguments, MCI reminds the Commission that it chose a productivity factor which was a "conservative minimum figure." MCI fails to point out that the Commission added a number of backstop measures, in addition to sharing, to its estimate of historical productivity to safeguard against any underestimate of historical productivity. The Commission added the 0.5% Consumer Productivity Dividend to ensure the first benefits of any future increases in achieved LEC productivity would accrue directly and totally to access customers.

5. MCI Incorrectly Calculated Return on Equity.

MCI has also presented misleading data on return on equity (ROE). First, MCI presented data for the Regional Bell Holding companies (RBHCs). Data are available for the RBOCs and for the price cap LECs in total, both of which would be a more